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THOMAS J. FOX
Chief Counsel

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AUG 25 1993

FCC MAIL ROOM

August 24, 1993

Office of the Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, DC 20554

Dear Sir or Madam:

Enclosed is an original and nine copies of initial comments to be filed in MM Docket No. 93-215.

Sincerely,

Thomas J. Fox

Thomas J. Fox
Counsel

Enclosures

No. of Copies rec'd 0+8
List A B C D E

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the matter of Implementation of the Cable Television Consumer Act of 1992 Rate Regulation	)	MM Docket No. 93-215

RECEIVED

AUG 25 1993

FCC MAIL ROOM

TO: The Commission

COMMENTS OF
THOMAS J. FOX
COUNSEL TO
NEW YORK STATE ASSEMBLY
COMMITTEE ON OVERSIGHT, ANALYSIS AND INVESTIGATION

1. Thomas J. Fox, Counsel to The New York State Assembly Committee on Oversight, Analysis and Investigation ("Committee") hereby submits initial comments in response to the Notice of Proposed Rulemaking ("NPRM") released in this docket on July 16, 1993.

2. The Committee is a legislative committee of general jurisdiction within the New York State Assembly. As such, the Committee is conducting a lengthy and ongoing examination of the cable television industry and rate regulation in New York State.

3. The Federal Communications Commission ("FCC") seeks comment generally on proposed rules for governing cost-of-service showings by cable operators seeking rates above levels determined by the FCC's benchmark and price cap method of determining rates.

4. The FCC proposals include affiliate transaction rules governing transactions between the regulated and unregulated portions of cable systems. (NPRM, para. 67). The NPRM correctly notes the danger that in affiliate transactions the regulated entity might buy at too high a price or sell at too low a price. The result can be that the regulated entity is used as a cash cow, that rates are unreasonably high and that subscribers ultimately foot the bill. The NPRM is entirely correct in finding that unreasonable affiliate payments should not find their way to subscribers' bills. (See NPRM, para. 68).

5. In proposing to deal with affiliate transactions, the NPRM offers the following definition of an affiliate:

> an entity with a five percent or greater ownership interest in the cable operator including general partnership interests, direct ownership interests, and stock interests in a corporation where such stockholders are officers or directors or who directly or indirectly own 5 percent or more of the outstanding stock, whether voting or nonvoting. (NPRM, para. 67 at n.67)

This proposed definition of an affiliate is too narrow to avoid the dangers recognized in the NPRM.

6. The NPRM proposal would include as an affiliate only an entity that is the parent of a cable operator. At least two other kinds of possible affiliate relationships may exist which would give rise to the potential for unreasonable affiliate transactions.

7. One such relationship would be where the cable operator is the parent of a subsidiary entity which does business with the cable operator. A second such relationship would be where a parent entity owns a cable operator subsidiary and the parent also owns another subsidiary which does business with the cable operator.

8. In either of these two relationships, a cable operator might incur unreasonable costs. For example, a parent entity might create separate unregulated subsidiaries engaged in the business of laying fiber optic lines or leasing real estate or vehicles to cable operators. A cable operator subsidiary of that parent entity might too easily buy too high from its sibling affiliate. If reasonable rates are to be ensured, cable companies cannot be allowed to find such easy means for incurring unreasonable costs, whether those means are found purposefully or serendipitously.

9. The problem of complicated corporate structures allowing regulated companies to be used as cash cows for nonregulated companies is not new. A noted, recent case occurred in New York State and is familiar to both the FCC and the Committee. The case involved a parent entity (NYNEX), a regulated subsidiary (New York Telephone) and several unregulated subsidiaries (MECO, NYNEX Properties, etc.). The FCC found that New York Telephone made millions of dollars of unreasonable payments to its sibling affiliates such as MECO. (See In the Matter of New York Telephone Co. and New England Telephone Co., 2/6/90 Order to Show Cause). The Committee investigated the difficulties of state

regulatory oversight of the same set of facts. (An Investigation of the Public Service Commission's Examination of Wrongdoing in New Telephone Company's Transactions with Unregulated NYNEX Subsidiaries, 1990 (copy annexed as Appendix)). The facts were essentially the same as those set forth in the hypothetical in paragraph 8, above.

10. The FCC should adopt a regulation that defines an affiliate broadly enough to include (1) entities that are subsidiaries of cable operators and (2) entities that share a parent with a cable operator. Such a definition is necessary to avoid the dangers of cross-subsidization and to ensure that cable rates are reasonable.

Respectfully submitted,

Thomas J. Fox, Counsel
New York State Assembly
Committee on Oversight,
Analysis and Investigation

August 24, 1993

APPENDIX A

AN INVESTIGATION OF THE PUBLIC SERVICE COMMISSION'S EXAMINATION OF WRONGDOING IN NEW YORK TELEPHONE COMPANY'S TRANSACTIONS WITH UNREGULATED NYNEX SUBSIDIARIES

BY

OVERSIGHT, ANALYSIS AND INVESTIGATION COMMITTEE STAFF

Principal research and drafting of this document
by
Tom Fox, Chief Committee Counsel

September, 1990

FINDINGS

-- There are credible allegations of wrongdoing in economic transactions between New York Telephone Company and unregulated NYNEX subsidiaries, which if true could cost ratepayers hundreds of millions of dollars.

-- The Public Service Commission (PSC) is inadequately examining these allegations thereby failing to protect New York State consumers.

-- The PSC is not adequately using its specific statutory and regulatory powers.

In particular, the investigatory and regulatory tools which the PSC is not adequately employing are (1) its power in rate cases to investigate overpayments in <u>individual</u> transactions, (2) its power to require full and timely disclosure of documents from unregulated affiliates of utilities, (3) the requirement that certain charges of unregulated affiliates to a utility not exceed the reasonable costs of performing the service--the PSC is supposed to review such contracts and may disapprove any contract which is not in the public interest--, and (4) the imposition of civil penalties for wrongdoing.

For each of these investigatory and regulatory tools, the PSC has an unnecessarily narrow view of its powers and has refused to act in ways to protect the public interest. Some of the PSC's positions may be arguable; others are simply wrong. The result is an inadequate investigation of wrongdoing.

The losers are ratepayers and the public interest. The winners can be utilities, unregulated affiliates or individuals operating within such companies. The public needs an aggressive watchdog to guard its interests. Our conclusion is that the PSC is not adequately fulfilling that role.

RECOMMENDATIONS

-- The PSC should immediately commence wider investigative proceedings into the allegations of economic and other wrongdoing which have been raised in the pending NYTEL rate case.

-- In its investigative inquiry, the PSC should fully employ its powers and authorities.

-- The PSC should investigate NYTEL overpayments in <u>all individual</u> transactions with unregulated affiliates.

-- The PSC should require NYTEL and its unregulated affiliates to fully disclose documents relevant to the costs of individual transactions.

-- The PSC should thoroughly review all NYTEL management, construction and engineering contracts with affiliates and should disapprove any contract which results in NYTEL being charged more than the reasonable cost of the service provided to NYTEL.

-- The PSC should initiate civil penalty proceedings for economic and other wrongdoing in connection with NYTEL affiliate transactions against any person or company for whom there is evidence of malfeasance, including allegations of sex parties in Florida.

-- In future dealings with all of the utilities which it regulates, the PSC should fully employ all of the investigatory and regulatory tools available to it.

The PSC should immediately begin to maximize the potential of the investigatory and regulatory tools that are at its disposal for protecting the public interest. This should be done within the context of rate case proceedings as well as in proceedings extraneous to rate cases.

ANALYSIS

The factual basis for concern about transactions between the New York Telephone Company (NYTEL) and its sibling subsidiaries of the NYNEX Corporation has been set forth in Chairman Brodsky's February 28, 1990, letter to Public Service Commission (PSC) members. (A copy of that letter is attached as appendix A). NYTEL is regulated by the PSC, which sets NYTEL's rates. Rates are supposed to cover the company's actual expenses as well as a reasonable profit for stockholders. The PSC usually allows a twelve percent rate of return on investment.

NYNEX is the sole stockholder of NYTEL. The PSC does not regulate NYNEX. In addition to owning NYTEL, NYNEX also owns nine other subsidiaries which are not regulated by the PSC. Many, if not all, of NYNEX's unregulated subsidiaries have been doing business with NYTEL over the past several years. There is substantial reason to believe that NYNEX has used NYTEL as a cash cow for its unregulated subsidiaries. NYNEX may have influenced NYTEL to buy goods and services at inflated prices from the unregulated subsidiaries. The unregulated subsidiaries' windfalls from the overcharges would accrue to the benefit of NYNEX's bottom line. However, the other side of NYNEX's ledger would not necessarily see a corresponding debit reflecting NYTEL's excess payments. In setting rates, the PSC will generally grant NYTEL a rate sufficient to cover all of its expenses, which would include undiscovered overpayments to the unregulated subsidiaries. Thus, the ultimate source of payment for the windfalls would be the NYTEL ratepayer; the ultimate beneficiary would be NYNEX.

SCOPE OF THE OVERPAYMENTS

The weight of the available evidence is that there is a substantial likelihood overpayments pervaded all of NYTEL's transactions with NYNEX's unregulated subsidiaries. The philosophical underpinning for the practice of overpayments is NYNEX's corporate policy of "corporate synergy." NYNEX mandated that all of its subsidiaries adhere to this policy. NYTEL has described "corporate synergy" as a benign policy which merely allows NYTEL to utilize the other subsidiaries' diversified capabilities in order to achieve some benefit to NYTEL. The principal theoretical benefit cited is that subsidiaries could purchase goods and services in sufficiently large quantities to obtain volume discounts which would be passed along to NYTEL.

However, "corporate synergy" has a dark side. There is considerable evidence that in actual practice "synergy" has meant that NYTEL was required to do business with the unregulated subsidiaries. They, in turn, viewed NYTEL as a captive customer and charged NYTEL accordingly.

Allegations and documentation regarding particular instances of NYTEL overpayments have been proffered to the Public Service Commission by at least a half dozen witnesses with first-hand knowledge of such events. These witnesses consist mostly of former personnel of NYTEL and of two of the unregulated subsidiaries. These personnel were all directly involved in transactions between NYTEL and the unregulated subsidiaries.

The unregulated subsidiaries implicated as overcharging, or attempting to overcharge, NYTEL include NYNEX Material Enterprises Company (MECO), NYNEX Business Information Systems Company (BISC), NYNEX Credit Company, NYNEX Properties Company, and Telco. The goods and services involved included office equipment removal, personal computers, computer mainframe leasing, and computer software.

There is not yet available evidence of overpayments on every single NYTEL transaction with every unregulated subsidiary. Witnesses with first hand knowledge of all such events have not come forward yet. However, the facts alleged by the available witnesses presents a powerful circumstantial case that all NYTEL-affiliate transactions must be considered suspect. Unfortunately, to date, the PSC has not pursued investigations into all NYTEL affiliate transactions, but rather has focussed only on a few transactions.

PSC PROCESSES FOR INVESTIGATING OVERPAYMENTS

There are unresolved allegations of NYTEL overpayments. The PSC's methods of investigating these allegations appear to be unsatisfactory both in the PSC's use of specific investigatory tools and in terms of the PSC's overall approach to the investigation.

What follows is an evaluation of how the PSC is using specific regulatory tools. Often the focus of the evaluation is not only the use of the tool in the NYTEL case, but also the PSC's overall use of the tool for all cases.

THE PENDING RATE CASE--METHOD OF ASSESSING OVERPAYMENTS

In the NYTEL settlement case, and again in the pending rate case, a major issue has been the method of determining the amount of NYTEL overpayments to MECo and other affiliated interests. The settlement proposed by PSC staff included an assessment of overpayments by measuring "excess profits" earned by NYTEL and its unregulated affiliates. Some of the settlement's opponents, including the Attorney General, urged the necessity of a comprehensive investigation of NYTEL imprudent overpayments on a per transaction basis. In an April 20, 1990, meeting, the PSC staff informed Committee staff that in the pending rate case the PSC will continue to use the excess profits method. The staff testimony actually submitted in the rate case has conformed to this approach. PSC staff offered several reasons as justifying this approach. None appears to be a valid justification for not fully investigating transactions.

The PSC staff explained that specific transactions will be examined but only when the PSC has particularized evidence of an imprudent payment by NYTEL. Unfortunately, this seems to be putting the cart before the horse. As mentioned above, the available evidence consists of specific instances of NYTEL overpayments to NYNEX subsidiaries. However, the specifics constitute evidence of a pattern of overpayments. Moreover, the contours of the pattern are fairly discernible from NYNEX's corporate synergy policy. The fact that all specific overpayments are not yet known is beside the point. The point is that the investigation has to be done in order to find the specifics.

A second reason proffered by the PSC staff is that a per transaction methodology is unnecessary because the excess profits method will reveal in a cumulative way all overpayments anyhow. This position is based on two faulty premises. One is that it presumes that a particular unregulated subsidiary would be profitable at the same rate that the PSC allows to NYTEL. In fact, there is no reason to presume that the unregulated affiliates would make any profit. It may well be that but for gouging NYTEL and its ratepayers, the unregulated affiliates would have lost money. Second, it presumes that the unregulated subsidiary, itself, did not make overpayments to other unregulated subsidiaries in a "daisy-chain."

A third reason proffered by the PSC staff was that a per transaction methodology was not feasible because it would require too much staff. However, at least as of April 20, the PSC staff had made no analysis of how much staff would actually be needed. In the absence of any such analysis, it seems unfair to conclude that it would be too costly. Additionally, staff had given no consideration to utilizing Public Service Law $ 96 [6] to conduct a per transaction analysis. That statute empowers the PSC to order the appointment of auditors at company expense. The PSC staff correctly pointed out that the statute only authorizes management and operations audits. However, management and operations audits would cover a large portion of NYTEL's transactions, especially in light of the expansive reading which the Court of Appeals has given to the term "management." See <u>New York Telephone Co. v. Public Service Commission</u>, 72 N.Y.2d 419 (1988).

DAISY CHAIN TRANSACTIONS

A recurring problem in the regulation of utilities in general and of NYTEL in particular is the phenomenon of "chain" or "daisy chain" transactions. A daisy chain transaction is a refinement of the practice in which a regulated utility buys an item at an inflated price from unregulated affiliate "A". One way of detecting and measuring the utility's overpayment to A is to determine A's markup above the price it paid. The daisy chain refinement is for A to buy the item from another unregulated affiliate "B". Thus, the unjustifiable profit will appear in B rather than in A, where the regulator may be wont to look. There have been credible allegations of daisy chain transactions among NYTEL, MECo and other unregulated NYNEX subsidiaries.

An adequate investigation of daisy chain transactions would require access to records of the transactions. Public Service Law $ 110[2] apparently grants the PSC the power to obtain those records. Subdivision 2 reads:

> 2. The commission shall have jurisdiction over affiliated interests having transactions...with utility corporations ... to the extent of <u>access to all accounts and records of such affiliated interests relating to such transactions</u> ... and to the extent of authority to require such reports to be submitted by such affiliated interests, as the commission may prescribe. (emphasis added)

The scope of the statutory authorization may be subject to different interpretations depending on the meaning of the words "relating to." Using the above utility, A, B hypothetical, it seems beyond dispute that the utility's and A's records of the sale from A to the utility should be available. While it may be arguable, the better argument would seem to be that A's records of its purchase of the item from B also "relate to" the transaction and, therefore, should be available.

Whether the statute requires disclosure of B's records of its sale to A and of B's purchase of the item is also arguable. If B never sells directly to the utility, it could be argued that B is not "an affiliated interest having transactions...with" the utility and that B's records consequently do not fall within the statute. On the other hand, B arguably would be "having transactions... with" the utility, albeit indirectly through the intermediary of A. This latter position would be even stronger if a fourth company, "C", is a holding company owning the utility, A, and B. C would certainly be an affiliated interest and it could be fairly argued that C is having transactions with the utility and that B's records belong to C.

In response to repeated questioning by the Oversight Committee, NYTEL has taken the position that the records of the utility, A, and B should be available to the PSC. Attached as appendix B is a May 17, 1990 letter from NYTEL counsel setting forth that position.

Surprisingly, the PSC has claimed less authority under section 110[2] than NYTEL concedes to the PSC. In the Spring of 1990, the PSC stated it does review records of utilities and affiliates "relating to transactions between the two." May 14, 1990 memorandum from PSC General Counsel, William Cowan [hereinafter Cowan] at 5. (A copy of this memorandum is annexed as appendix C) The PSC opined, however, that "[e]xisting statutes dealing with affiliated transactions are too restrictive because transactions between unregulated affiliates and third parties are not permitted." Id. Using our utility, A and B hypothetical, the PSC's position seems to be that the utility's and A's records of the utility-A transaction are available. But, neither A's nor B's records of the A-B transaction are available.

The PSC espoused a somewhat different position in February, 1989. The PSC proffered a departmental bill amending section 110[2]. In its supporting memorandum, the PSC stated

> Although we believe that the existing authority in Public Service Law §110 (2) authorizes access to affiliates' books and records, utilities have challenged that view and this proposal would clarify the extent of the Commission's access to records. PSC Memorandum at 3. (A copy of the memorandum is annexed as appendix D).

In 1989, the main problem did not seem to be a lack of statutory authority, but rather seemed to be obstructionism on the part of the companies. As the PSC stated, "requests for information are often unanswered, refused and in many instances, responses are unreasonably slow." Id. These delays were especially troublesome in rate cases where investigations had to occur within the 11 month time frame allowed for the entire case. Id. The PSC's proposed remedy was to give the PSC access to affiliates's records "at any time" and to authorize the PSC in a rate case to disallow "costs associated with" an affiliate if access is denied. A. 7341 (1989).

One point in particular comes shining through the PSC's words in its 1989 memorandum. Overpayments to affiliates are a grave problem, especially with NYTEL. "This concern reaches major proportions in investigations of New York Telephone Corporation rates....The implications of misconduct are very serious and the opportunities for careless or purposeful subsidies to an affiliate abound." PSC Memorandum at 3.

The problem is real; the problem is known. While the PSC's statutory authority to get all relevant records may not be absolutely clear, there certainly is a need and a basis for aggressively asserting whatever authority the statute arguably does give. In the face of company intransigence, this probably means litigating the issue. The most disturbing aspect of the PSC's behavior regarding this regulatory tool is that, according to the PSC staff, the PSC has not taken steps to force the issue. Instead, when confronted with intransigence, the PSC seems to acquiesce.

REVIEW OF AFFILIATE CONTRACTS

The most direct power to control affiliate contracts is afforded to the PSC by Public Service Law § 110 [3]. This, too, seems to be a tool which the PSC does not fully utilize. Subdivision 3 provides that:

> 3. No management, construction, engineering or similar contract hereafter made, with any affiliate interest ... shall be effective unless it shall have first been filed with the commission, and no charge for any such ... service, whether made pursuant to contract or otherwise, shall exceed the reasonable cost of performing such service. In any proceeding to determine the reasonable cost of such charge or service the burden of proof shall be on the company. If it be found that any such contract is not in the public interest, the commission, after investigation and hearing, is hereby authorized to disapprove such contract.

The kinds of contracts included within the scope of this subdivision are quite broad. The Court of Appeals has given an expansive interpretation to the term "management contract." New York Telephone Company v. Public Service Commission, 72 N.Y.2d 419 (1988). Moreover, the statute's inclusion of "similar contracts" certainly provides it with a fairly wide scope.

The reason for the statute is clear: "[t]he underlying purpose of the legislation was to prevent the utilities from insulating themselves from regulatory control through these contractual devices so that they could charge large fees 'at the expense of the operating company and ultimately the consumer.'" Id. at 427

The statute calls for all such contracts to be filed. No doubt anticipating that utilities deal without written contracts, the statute also applies to any "charge... whether made pursuant to contract or otherwise." The statute calls for the PSC to conduct investigations and hold hearings. At a hearing the company bears the burden of proving the reasonableness of cost.

Oversight Committee staff have asked the PSC a series of questions about how the PSC uses subdivision 3. The PSC's response was not entirely clear. See Cowan at 1-6. Rather than describing a direct method in which subdivision 3 is applied, the PSC described six indirect methods of enforcing the filing requirement. However, the six methods all seem only tangentially related to the mechanics and purpose of subdivision 3. The clear implication is that subdivision 3 is generally not used.

Some of the six methods described by the PSC actually raise more questions than they answer. For example, the third method cited is the utility's annual report. Cowan at 2. In fact, the annual reports consist of composite numbers which shed no light on the reasonableness of particular expenses. Similarly, the fourth method cited, which requires generalized statements of affiliate transactions, would also provide only composite figures. None of the methods cited ever get at the central questions: (1) how much was paid for a particular good or service provided pursuant to a contract and (2) was that cost reasonable.

One point is fairly clear from the PSC's response. The PSC is generally not using the hearing mechanism. Cowan at 4. The full use of that mechanism would allow the PSC to not merely make accounting "disallowances" for ratemaking purposes, it would also allow the PSC to disapprove and cancel the contract. International Railway Company v. Public Service Commission, 264 App. Div. 506 (3d Dept. 1942), affd., 289 N.Y. 830. Instead, as with civil penalties, the PSC seems to rely on rate cases for enforcement. Cowan at 4.

The one striking recent exception to the PSC's pattern of using subdivision 3 was the PSC's disapproval of a contract for telephone directory services between NYTEL and NYNEX IRC. See New York Telephone Company v. Public Service Commission, supra. However, one can only wonder why other NYTEL contracts have not been the subject of timely hearings for cancellation.

A case in point is MECO's contractual dealings with NYTEL. There are two known contractual arrangements, an "Engineered Services Agreement" and a "Standard Supply Contract." Only the latter was filed--on January 1, 1984. The contract was brief and contained little, if anything, to describe what the contract would cost NYTEL. Pursuant to these contractual arrangements NYTEL has made huge overpayments to MECO.

The PSC staff's own 1987 report identified and documented problems with these contractual arrangements. The contract's terms were vague; it was impossible to determine MECO's costs for performing service; but, there was clear evidence that MECO was obtaining unreasonable profits. A December, 1989, PSC staff audit showed that beginning in 1984 NYTEL overpaid MECO $25 to $28 million pursuant to this contract in just one area which the PSC examined--central office equipment removal.

Despite clear evidence that MECO's charges to NYTEL were exceeding the reasonable cost of performing services, MECO and NYTEL continued to transact business pursuant to these contractual arrangements until 1990. The PSC's 1988 "excess profits adjustment" for excess MECO profits was an inadequate remedy for these unreasonable costs. The excess profits calculation does not take into account imprudent losses and wasteful expenditures by MECO.

The appropriate remedies for these unreasonable costs would include the PSC actually determining the costs of all transactions made pursuant to the contract and, further, to determine the reasonable cost of performing those services. Moreover, where unreasonable costs are resulting from a contract, the PSC should disapprove the contract in its entirety. As the Appellate Division has said in describing the purpose of subdivision 3, "[t]he legislature can hardly have intended that a contract against the public interest should be left hanging in the air." International Railway Commission, supra, 264 App. Div at 512.

The PSC's response requires that any opinion on the PSC's use of Section 110(3) must be tentative. However, that tentative opinion would justifiably be that the PSC is not fully and effectively using this regulatory tool.

CIVIL PENALTIES

Public Service Law §§ 24-26 empower the PSC to bring civil penalty actions against public utilities which violate the Public Service Law or a PSC order. The amount of the penalty may be up to $100,000 per violation and even more for certain specific violations. Public Service Law § 25. Utility employees may be held personally liable. Id., subdivision 2. Including penalty costs in a utility's rate base is forbidden. Id., subdivision 6.

These civil penalty provisions are ostensibly an important regulatory tool. In 1986 the Legislature increased the amount of the penalties ten-fold in order to enhance their usefulness. McKinney's Session Laws, L. 1986, ch.375. The Assembly sponsor's memorandum in support of the bill explained that:

> This bill would strengthen the monetary sanctions that the Public Service Commission can impose on public utilities and their agents or officers....It is designed to provide an effective deterrent to hazardous, unsafe and unlawful activities by multimillion dollar utilities , especially since these penalties may not be passed along to ratepayers.

Noting that a utility retains monopoly power "even when it flouts the law," the sponsor explained that the bill's increase in penalty amounts was necessary to avoid the abuse of monopoly power. Governor's Bill Jacket, Memorandum in Support of Legislation, A. 3966 (Hoyt). The PSC supported the bill in 1986. Governor's Bill Jacket, Memorandum from PSC Chair to Governor's Counsel.

The PSC, however, has avoided use of its civil penalty tool and has done so for fallacious reasons. The PSC's use of the penalty provisions was described in the May 14, 1990, memorandum from PSC General Counsel, William Cowan, included herein as appendix C. The PSC uses penalty actions "as a last resort." The PSC's "view has resulted from the fact that penalty actions are considered quasi-penal and the standard of proof is 'beyond a reasonable doubt.'" Cowan at 10. In response to an Oversight Committee request for the legal authority for this view, PSC Deputy General Counsel John Crary provided a memorandum with three case citations. [A copy of that memorandum is attached as appendix E.]

The PSC's explanation of the standard of proof as being "beyond a reasonable doubt" is wrong. The three cases cited in the Crary memorandum have nothing to do with the standard of proof. In each case the issue was how to interpret a particular statute. Each of the courts did describe the particular statutes as being "penal" in nature because the statutes provided for fines or penalties. However, the courts' descriptions had nothing to do with the standard of proof. Rather, each court was invoking a traditional rule of statutory construction: that penal statutes are to be strictly or narrowly construed. See McKinney's Statutes § 271.

The imposition of fines and penalties does not require proof beyond a reasonable doubt. As the Court of Appeals has stated:

> Civil fines and penalties are routinely imposed by administrative action where the predicate therefor has been found on lesser standards than guilt beyond a reasonable doubt. Rosenthal v. Hartnett, 36 N.Y.2d 269, 274 (1975).

Especially in light of this general rule described by the Court of Appeals, it seems inappropriate for the PSC to be basing its legal position on the cases cited in the Crary memorandum. If there is any genuine question as to the standard of proof, what would be appropriate would be for the PSC to have fully litigated the issue through the courts and to have a definitive judicial ruling on the issue.

The PSC further explained its use, or non-use, of the penalty provisions by noting that penalty money goes into the State's General Fund and is "not used for the benefit of the ratepayers harmed by the transgression." The PSC apparently considers it preferable "to consider a company's violations in setting a company's return on equity [which] would provide direct benefits to ratepayers." Cowan at 11. This rationale is also without merit. Just and reasonable rates are legally mandated; they are not optional. Civil penalties are designed to be a punitive action imposed in addition to any adjustments made to rate bases. This legislative intent is evident in Public Service Law § 25, subdivision 6, which forbids the inclusion of penalty payments in rate bases.

An example of the undesirable effect of the PSC's view of the burden of proof is a recent case involving misconduct by Columbia Gas. The PSC staff, itself, has cited this case as an example of how the supposed "beyond a reasonable doubt" standard causes the PSC to not pursue civil penalties. PSC staff told the Oversight Committee that Columbia Gas's exposure for civil penalties was $2 million. However, the PSC settled the case for a $40,000 penalty and remediation. PSC staff did indicate that obtaining remediation was an important element in the negotiated settlement. However, the beyond a reasonable doubt standard was a major factor inducing the PSC to settle.

Two aspects of the PSC's position on the use of penalty provisions are especially troubling. One is that the position apparently is based on incorrect legal analysis. The second is that the position bespeaks a laissez-faire attitude towards utility regulation rather than the attitude of an aggressive watchdog for the public's interest.

ADDITIONAL REGULATORY PROCEDURES

Since the time when this review was undertaken, significant events have occurred in the pending NYTEL rate case. These events raise questions regarding the use of other regulatory tools.

Subpoenas and depositions do not seem to be freely granted to parties opposing rate increases. In fact, it is our understanding that the PSC never issues subpoenas. The PSC's standards for granting and actual use of these devices are issues worth pursuing.

NYTEL's use of a "trade secrets" privilege to shield potentially relevant information is another such issue. The PSC's standards for applying the privilege as well as its procedures for adjudicating claims of privilege are of interest.

The PSC, itself, has expressed concern about utilities' use of delaying tactics in rate cases. It would be useful to know what sanctions the PSC uses to deter utilities' delaying tactics.

MOTION FOR A SPECIAL INVESTIGATION IN THE RATE CASE

In the pending NYTEL rate case the Consumer Protection Board and Attorney General have made a motion for a special investigation, apart from the rate case, of NYTEL affiliate transactions. The PSC has deferred decision on the motion until September 18, 1990, when the PSC is scheduled to receive a report from PSC counsel William Cowan, who is investigating some affiliate transactions. This pending investigation and decision have the potential for the PSC to alter its course of action.

Whether this will happen remains to be seen. An investigation that focusses only on a narrow set of facts, such as the so-called "perverts' conventions", will not address this report's broader criticism that all manner of affiliate business transactions should be investigated. Moreover, any PSC action short of the aggressive use of the full range of regulatory tools, such as contract disapprovals and civil penalties, would not dull the overall point of this report.

THE ASSEMBLY
STATE OF NEW YORK
ALBANY

RICHARD L. BRODSKY
Assemblyman 86th District
Westchester County

CHAIRMAN
Committee on Oversight, Analysis
and Investigations

Appendix A

February 28, 1990

Mr. Peter A. Bradford
Chairman
Public Service Commission
Empire State Plaza
Agency Bldg. 3
Albany, NY 12223

Re: New York Telephone Company--Case #28961

Dear Mr. Bradford:

I urge you to reject the Proposed Comprehensive Regulatory Issues Settlement Plan for New York Telephone Company (the Plan). The Plan raises significant economic, regulatory and ethical problems. These unresolved issues ought to cause the PSC to reject the Plan, and I urge you to do so.

In part, the Plan purports to resolve investigations into past overpayments by NYTEL to unregulated NYNEX subsidiaries, NYNEX Material Enterprises (MECO) and NYNEX Systems Marketing (NSM). This element of the Plan is particularly inequitable to ratepayers in light of the considerable body of evidence that NYNEX subsidiaries grossly overcharged NYTEL for goods and services.

I realize that due to the rate moratorium, these overcharges have not yet been passed on to ratepayers. However, the overcharges do appear in the form of an unjustly inflated NYTEL rate base. This rate base is factored into the Plan"s proposed $445 million 1991 rate hike and will also be factored into rates set in the future. Thus, beginning in 1991, ratepayers will continue to pay for the overcharges year after year because the rate base will be forever bloated. The Plan's provision for a $10.7 million NYTEL rate base reduction to satisfy the overpayments is entirely unsatisfactory.

Examination of MECO's removal of NYTEL's central office equipment is instructive in assessing the true extent of overpayments. The record shows that between 1984 and 1988 NYTEL incurred $25-28 million in excess costs in the removal of its central office equipment. (12/89 PSC Staff Audit [hereinafter Staff Audit] at 5, 163). This fact alone should justify a downward adjustment of $25-28 million to the rate base. Additionally, the PSC staff found that a further $61 million in reduced depreciation expense should be achieved by NYTEL through changes in the removal process for central office equipment. (Staff Audit at 5, 186).

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The central office equipment removal overcharges appear to be the tip of an iceberg. The PSC staff's own audit of central office equipment removal noted that the similar problems may have well existed in central office equipment installation. (Staff Audit at 14). Moreover, there were many other functions which MECO performed for NYTEL where there may have been overcharges. Recognizing this, the PSC staff audit recommended a more comprehensive investigation of the entire NYTEL/MECO relationship. That recommendation should be accepted by the Commission.

Within the past few weeks, the Federal Communications Commission has issued findings that NYTEL and New England Telephone paid $118.5 million more than the fair costs of goods and services provided by MECO. (2/6/90 Order to Show Cause in The Matter of New York Telephone Co. and New England Telephone Co.). Concededly, $35.5 million of that amount was for interstate ratepayers. Of the remaining $83 million, some portion, perhaps 43%, should be apportioned to New England Telephone. (See 12/29/90 FCC Staff Audit at 6). That would leave approximately $47.3 million in NYTEL intrastate overpayments. Given these numbers, the Plan's $10.7 million rate base reduction must be rejected as being grossly inadequate.

The MECO/NYTEL transactions should be the beginning, not the end, of the investigation into NYTEL overpayments to unregulated NYNEX subsidiaries. A series of credible, informed witnesses have testified before the PSC that NYNEX has imposed on NYTEL a policy of "corporate synergy," the beneficiary of which was NYNEX, not NYTEL. Stripped to its essence, this policy requires NYTEL to buy from unregulated subsidiaries when it increases the NYNEX bottomline, even if it means that NYTEL and its customers foot a higher bill. The MECO overcharges are no more than the logical application of this policy. But, MECO is only one of several NYNEX subsidiaries in a position to overcharge NYTEL.

The other NYNEX subsidiaries doing business with NYTEL include NYNEX Information Resources Company, NYNEX Systems Marketing Company, NYNEX Mobile Communications Company, NYNEX Properties Company, NYNEX Credit Company, and NYNEX Service Company. (NYTEL's FY1988 Form 10-K filed with the SEC). There are strong indications that these subsidiaries may have engaged in overpayments like those uncovered in the MECO/NYTEL transactions.

For NYNEX Systems Marketing Company (NSM), the Plan itself contains an implicit recognition of the possibility of overpayments. The Plan calls for the transfer of NSM's marketing and account management services to NYTEL. The Plan also calls for a one-time payment by NSM into an educational endowment. There is a palpable sense that this is an attempt at "rough justice" for overpayments by NYTEL to NSM and its predecessor, NYNEX Business Information Systems Company. There seems little justice for ratepayers in this scheme. They are entitled to a full accounting of the reasonableness of NSM charges and, if overcharges occurred, they are entitled to have that fact reflected in their future rates.

Another subsidiary, NYNEX Information Resources Company, engaged in dealings with NYTEL which the PSC has previously found to be unacceptable because NYTEL was being unfairly used. (See New York Telephone v. Public Service Commission, 72 N.Y.2d 419 (1988)). The pattern is clear. The NYNEX "corporate synergy" policy has resulted in all of the unregulated NYNEX subsidiaries viewing NYTEL as suitable prey for overcharges. All transactions between NYTEL and the unregulated subsidiaries are suspect and merit thorough investigation.

The amount of overpayments may have been underestimated even in the FCC's method of calculating the MECO/NYTEL transactions. The FCC based its calculations on an analysis of the amount of profits earned by MECO. However, there is substantial evidence before the PSC that even the high MECO profits do not reflect all NYNEX subsidiary overcharges to NYTEL. The record reflects that other NYNEX subsidiaries, such as NYNEX Credit Corporation (NCC) and NYNEX Business Information Systems Company (BISC), overcharged MECO for goods and services ultimately destined for NYTEL. MECO would pass the inflated costs along to NYTEL, but the excess profits would not go to MECO. Rather, the benefit of the overcharges would go initially to NCC or BISC, before ultimately going to the holding company, NYNEX. (See 2/5/90 Recommended Decision of ALJ Harrison [hereinafter ALJ] at 74-75).

Thus, merely looking at the excess profits of a particular unregulated NYNEX subsidiary will not reveal the full amount of overpayments by NYTEL. Only by examining particular transactions for the reasonableness of NYTEL's costs can the true amounts of overpayments be determined. As the Department of Law cogently argues, there should be a generic prudence investigation to identify and quantify all imprudent expenditures. (ALJ at 77). Such an investigation, and rejection of the Plan, appears necessary in order for the PSC to fulfill its statutory mandate to determine "just and reasonable rates." (Public Service Law § 97[1]).

The Plan's proponents within the PSC staff appear to have abandoned any attempt at this sort of quantification of overpayments. They characterize the real quid pro quo for termination of the investigations as being the corporate reorganization of MECO and NSM. They concede an inability to place a dollar value on this reorganization. Yet, they assert that its value is more than the amount of NYTEL overpayments which have not even been investigated. (ALJ at 78). This is simply unacceptable--as is the Plan, itself.

The supposed benefit of MECO and NSM reorganization is, in fact, illusory. The parties in opposition have already demonstrated that the extreme vagueness of the terms makes this part of the Plan virtually unenforceable. (See ALJ at 66-69). Even more importantly, PSC staff's premise that reorganization is necessary to control the "perverse incentive problem" of NYTEL overpayments is faulty. (See ALJ at 64).

It may be true that the PSC does not have the power to dictate the NYNEX corporate structure. However, the PSC does have the power to stop deleterious deals between NYTEL and the unregulated NYNEX subsidiaries. Section 110[3] of the Public Service Law requires that "management, construction, engineering and similar contract[s]" with affiliates be filed with the PSC.

No affiliate charge for such a service may exceed the "reasonable cost" for performing the service. NYTEL would have the burden of proving the reasonableness of the cost. If the contract "is not in the public interest," the PSC is "authorized to disapprove such contract." With this power, the PSC should be able to stop the misdealings between NYTEL and the unregulated NYNEX subsidiaries. Indeed, the PSC has done so in at least one instance involving NYNEX Information Resources Company and the Court of Appeals has upheld the PSC's authority to do so. New York Telephone v. Public Service Commission, supra.

The weight of the evidence before the PSC is that the Plan is not in the interest of New York ratepayers. NYTEL has been grossly overcharged by unregulated NYNEX subsidiaries. If the amounts of those overcharges are not fully investigated and quantified, ratepayers will forever pay unjustly inflated rates. It would be unconscionable for the PSC to bargain away just and reasonable rates in exchange for corporate reorganization. Reorganization would be merely a tool to prevent affiliate misdealings. Preventing such misdealings is a power the PSC already has. Thus, I urge you to undertake a complete and thorough investigation of NYTEL's transactions with unregulated NYNEX subsidiaries. If such an investigation requires rejection of the Plan as a whole, so be it.

The NYNEX subsidiaries' wrongdoing ought to be systematically explored and judged. The PSC ought not to lose sight of its role as the enforcer of the moral authority of the Public Service Law as well as the guardian of the pocketbooks of ratepayers. I urge, in the strongest terms, that the Plan be rejected as inconsistent with law, policy, morality and the duty of the PSC to protect these vital interests.

Sincerely,

Richard Brodsky
Chairman, Oversight, Analysis
& Investigation Committee

Appendix B

New York Telephone

A NYNEX Company

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Michael Flynn
Attorney

May 17, 1990

Richard L. Brodsky
Assemblyman
Room 731
Legislative Office Building
Albany, New York 12248

Re: NYNEX Affiliated Transactions

Dear Assemblyman Brodsky:

This responds to your letter of May 10, 1990 to Robert Anderson concerning the current authority of the Public Service Commission to gain access to accounts and records related to "chained" transactions between New York Telephone Company and its affiliates.

Public Service Law §110(2), as currently codified, is broad enough to cover chained transactions between affiliates. Thus, referring to the example in your May 10 letter regarding a transaction from Affiliate B to Affiliate A to the Company, the statute permits access to the accounts and records of the Company and both Affiliates A and B.

Very truly yours,

Michael Flynn

Appendix C

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

Interoffice Memorandum

May 14, 1990

TO: Tom Fox, Counsel
Committee on Oversight, Analysis and Investigations

FROM: William J. Cowan, General Counsel
Department of Public Service

SUBJECT: New York Telephone Affiliated Transactions

This memo is a response to the questions in your April 26 letter relating to the application of Public Service Law Section 110(3) to the transactions between New York Telephone and its affiliates.

1. Since divestiture, has the PSC required the filing of all management, construction, engineering or similar contracts between NYTEL and its NYNEX affiliates? if so, please describe how the requirement was imposed and how compliance was monitored.

PSL section 110(3) requires the filing of a contract before it can become effective. Therefore, the legislature directly imposed the requirement that any management, construction, engineering or similar contract must be filed with the Commission before it can become effective. Our regulation of the companies provides several methods of enforcing the filing requirement. First, in each rate proceeding a company would include in the costs it seeks to recover in its rates any payments made pursuant to an affiliated contract. The Commission has the authority to deny the recovery in rates of any payments made pursuant to an